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Tax-Exempt Organizations Face New Tax Penalty on Excess Compensation — Due Diligence and Minimization

**J. MARC FOSSE AND
SERENA AISENMAN**

FEBRUARY, 2018

The "Tax Cuts and Jobs Act" added a new 21% tax penalty on "excess compensation" paid by most tax-exempt organizations to their top-five highest compensated employees. The penalty is found under section 4960 of the Internal Revenue Code (the "Code"), and it ties the amount of the penalty to the corporate tax rate, which is currently 21%. Importantly, this penalty is paid by the employer. Nothing under new Code section 4960 actually changes the employee's tax liability for any compensation paid. For that reason, it will be up to the organization's board of directors or trustees to determine what, if any, action should be taken by a tax-exempt organization to minimize the effects of the tax penalty.



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Trucker Huss Director Joseph Faucher Recognized by Super Lawyers in Southern California

Trucker Huss APC is pleased to announce that Director Joseph C. Faucher has been selected to the 2018 Southern California Super Lawyers list. Joe has received recognition from Southern California Super Lawyers for several years running.

Super Lawyers, part of Thomson Reuters, is a rating service of outstanding lawyers from more than 70 practice areas who have attained a high degree of peer recognition and professional achievement. The annual selections are made using a patented multiphase process that includes a statewide survey of lawyers, an independent research evaluation of candidates and peer reviews by practice area.

Faucher has been litigating ERISA matters and other employee benefit related cases for nearly 30 years. He was recently involved in a high-profile ESOP litigation matter where his work was instrumental in bringing about a settlement, on the eve of trial, for a fraction of the DOL's original demand. He is a frequent speaker on ERISA and employee benefits litigation subjects, and has written numerous articles and white papers on topics of interest to benefit plan sponsors, fiduciaries, service providers and other attorneys.



This article explains who is subject to the penalty and how it works. It also explains the standards boards will need to consider in making these decisions and then outlines strategies that organizations could implement to minimize the amount of the excise tax.

Applicable Tax-Exempt Organizations

The penalty applies to all "applicable tax-exempt organizations." Code section 4960 defines this group very broadly. The group includes any organizations that are exempt from federal income tax under Code section 501(a), governmental instrumentalities exempt from federal income tax under Code section 115, Code section 521(b)(1) farmers' cooperatives and Code section 527(e)(1) political organizations.

Code section 501(a) exempts from federal income tax all organizations listed in Code sections 501(b) and 501(c). Those listed organizations not only include the widely used exemption for Code section 501(c)(3) organizations (i.e., public charities and private foundations), but also most private tax-exempt organizations. Code section 115 governmental instrumentalities are defined as organizations that perform essential functions of, and whose income accrues to, a state government or its political subdivisions. State governments and political subdivisions are not subject to the excise tax. To be a political subdivision, an organization must have been delegated authority to exercise one or more of the state's sovereign powers — taxing authority, police power or eminent domain. These

organizations are the ones you generally think of as being part of the government, such as counties, townships, cities, police departments, public water and sanitation districts, and school districts. These entities are generally exempt from taxation under the Constitutional doctrine of intergovernmental immunity, under which states and federal governments do not typically tax each other.

The new law does not limit the number of organizations subject to the tax penalty based on whether the organization is part of a “controlled group” or “single employer,” as defined under Code section 414. Unless the IRS provides guidance to the contrary, it appears the excise tax could apply at each level of an organization and not just the parent organization. The excise tax also applies to any compensation paid to a covered employee by certain organizations that are related to an applicable tax-exempt organization. A “related organization” is defined as any person or governmental entity that is related to the applicable tax-exempt organization in one of the following ways:

- Controls or is controlled by the applicable tax-exempt organization;
- Is controlled by one or more persons that control the applicable tax-exempt organization;
- Is a supported organization (as defined in Code section 509(f)(3));
- Is a supporting organization (as defined in Code section 509(a)(3)); or
- In the case of a voluntary employee benefit association (VEBA), establishes, maintains, or makes contributions to the VEBA.

The statute provides that if more than one employer pays compensation to a covered employee, which results in excess compensation payments, then each employer pays a pro-rata share of the tax penalty. It does not provide that the related organizations pay the excise tax (unless, of course, the related organization is also an employer).

Covered Employee

A “covered employee” is any of the five highest paid employees of an applicable tax-exempt organization for any taxable year commencing after December 31, 2016. Once an employee is identified as a covered employee of the organization, he or she will be deemed a covered

employee “forever” with respect to any compensation paid by the organization, or any related organization, to that employee. For that reason, many tax-exempt organizations will eventually have more than five covered employees. This is important because post-termination payments to a covered employee will also be included to determine if the covered employee has received excess compensation in any taxable year. (Note that distributions from tax-qualified retirement plans under Code sections 401(a), 403(b), and 457(b) are not counted for purposes of determining excess compensation, but distributions from a Code section 457(f) plan are included.)

Excess Compensation

“Excess compensation” means any remuneration paid to a “covered employee” that either:

- Exceeds \$1,000,000 in any taxable year of the organization beginning after December 31, 2017, or
- Is deemed to be an “excess parachute payment.”

For purposes of determining if the penalty is triggered, remuneration means “wages” as defined under Code section 3401(a). (These wages are very similar to Form W-2 wages.) The following types of compensation will not be treated as includible remuneration:

- Payments from tax-qualified plans;
- Benefits paid from a 403(b) or 457(b) plan;
- Payments for medical or veterinary services performed by a medical or veterinary professional; or
- Payments to a non-highly compensated employee (as determined by Code section 414(q)).

Interestingly, Congress did not grandfather existing written compensation contracts, which it did do with respect to excess compensation paid at publicly traded for-profit corporations.

Excess Parachute Payments

A “parachute payment” is any payment in the nature of compensation to (or for the benefit of) a covered employee if:

- The payment is contingent on the employee’s separation from employment with the employer (no change of control is needed), and

- The present value of the contingent payment equals or exceeds three times the base amount (as defined under Code section 280G(b)(3)).

The base amount is the covered employee's average taxable wages for the past five years (or if shorter, then the shorter period). If the severance pay exceeds three times this base amount, then the amount of severance that exceeds the base amount is subject to the excise tax. For example, if a covered employee were receiving \$2,000,000 in severance pay and the employee's base amount (average compensation) was \$600,000, then the severance would exceed three times the base amount and the severance pay in excess of the base amount (\$1,400,000) would be subject to the tax penalty.

Fiduciary Duties

Members of an organization's board of directors or trustees owe fiduciary duties to the organization. These duties vary from state to state, but generally include the duties of care and loyalty. These duties generally require that when the board makes a decision on behalf of the organization, it must act in an informed manner, in good faith, and based on the honest belief that the action taken was in the best interest of the organization. If the board decision was well informed and taken in good faith, then a court will apply the business judgment rule to determine whether the board's decision was proper. The business judgment rule provides that the board decision and action will be considered to be made in the best interest of the organization if there is any rational basis for the directors' decision or action. In order for a board to establish that it acted on an informed basis and in good faith, the board should obtain appropriate information to:

- Identify current and potential covered employees;
- Determine potential penalties for the organization;
- Identify potential compensation restructuring to minimize excess compensation and parachute payments; and
- Balance the costs of the penalties against recruiting and retention needs of the organization and the costs of implementing any compensation restructuring.

If the harm to the organization's recruiting and retention needs are too great, then the excise taxes may become

part of the cost of doing business. However, boards will want to demonstrate that they were well informed and considered these issues in good faith.

Minimizing Tax Penalties

There are a number of ways that affected organizations can minimize the new tax penalty. For example:

- Maximize benefits under tax-qualified retirement plans. Organizations should review whether implementing a defined benefit plan, defined contribution, QSERP, or Code sections 403(b) or 457(b) plans can reduce the amount of compensation that would have been treated as excess compensation in a taxable year.
- Consider alternative methods of deferring compensation, such as a Code section 457(f) plan or a split-dollar life arrangement.
- A traditional problem with Code section 457(f) plans has been that the entire benefit is included in income in a single lump sum when the benefit vests. However, the proposed Code section 457(f) regulations (which can currently be relied on) now provide several methods that can be used to spread these payments out over time, which could enable the organization to avoid accruing post-termination payments in excess of \$1,000,000. These methods include:
 - *Post-Termination Non-Compete Periods.* For example, some not-for-profit hospitals have an interest in their executives not competing for talent and fundraising after termination of employment. A post-termination non-competes provision may be treated as a period during which the compensation is unvested, and could vest in tranches to spread payments over time. The tax penalties do not apply to compensation until it is vested. Also, because Code section 457(f) plans are covered by the Employee Retirement Income Security Act (ERISA), even California's laws against non-competes provisions are preempted.
 - *Rolling Vesting.* Another way to control the timing of payments from a Code section 457(f) plan is by implementing vesting extensions, sometimes referred to as "rolling" vesting. The proposed regulations now permit an organization to extend

a current vesting date if (1) an agreement extending the vesting date is entered into 90 days before the original vesting date, (2) the vesting date is extended by no less than two years, and (3) the employer adds a contribution to the plan that is greater than 25% of the current value of what the employee's benefit would have been on the original vesting date.

- o *Short-Term Deferral Exception.* Lastly, an organization can take advantage of the addition of a short-term deferral exemption now available under the Code section 457(f) proposed regulations. By using the short-term deferral exemption, the pay-at-vesting rule does not apply and the organization can better control when the payments are made and taxed.

We will be monitoring future IRS guidance regarding how the excise tax is to be applied to applicable tax-exempt

organizations, and we will post updates as they become available. At this time, applicable tax-exempt organizations should begin the diligence process of determining who will be a covered employee beginning with the 2017 taxable year and how much the potential excise tax could be. Then, the difficult work will begin: to determine if the organization can minimize the cost of the excise tax while maintaining its recruiting and retention needs for top executives to run the organization. These discussions may require modeling of deferred compensation to later years to see if the amounts can be spread out in an acceptable manner to avoid the excise tax while providing value to the executive.

We would be happy to discuss with your organization this diligence process and potential strategies to reduce compensation that will be subject to the excise tax. Please don't hesitate to contact the firm with any questions you may have.

DOL Announces April 1, 2018 Applicability Date for Final Rule Amending Claims Procedure for Disability Benefits

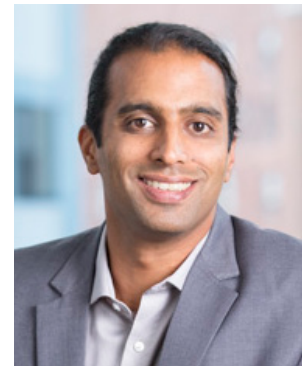
YATINDRA PANDYA

FEBRUARY, 2018

On January 5, 2018, the Department of Labor (DOL) announced April 1, 2018, as the applicability date for the final rule which revises regulations governing disability benefit claims (the "Final Rule"). Published in the Federal Register on December 19, 2016, the Final Rule revised the claims regulations governing disability benefits provided under employee benefit plans subject to the Employee Retirement Income Security Act (ERISA). For more details on the Final Rule, see the [article by Tiffany Santos](#).

The Final Rule was originally scheduled to apply to disability claims filed on or after January 1, 2018. However, in November 2017, the DOL announced that the applicability of the Final Rule would be delayed 90 days from January 1, 2018, to April 1, 2018, to give stakeholders the

opportunity to submit additional data on the costs and benefits of the Final Rule. Certain stakeholders and others had argued that the Final Rule would impose unnecessary regulatory burdens on plan sponsors and would significantly impair workers' access to disability insurance



benefits. For more background on the delay see the [article](#) by Yatindra Pandya and Jahiz Agard.

In its news release, the DOL stated it received approximately 200 comments from stakeholders on both sides of the debate during the 60-day comment window that ended on December 11, 2017. However, only a few commenters responded substantively to the DOL's request for quantitative data, and those comments were insufficient to persuade the DOL to revise the Final Rule or delay its applicability date beyond April 1, 2018. Consequently, the enhanced protections afforded by the Final Rule apply to all disability claims filed after April 1, 2018, within the context of any ERISA plan, if benefits are provided based upon the plan's finding of disability.

To ensure compliance with the Final Rule, plan sponsors and administrators should perform the following tasks, as applicable:

- Identify all ERISA plans which provide disability benefits
- Amend plan documents
- Review and revise claims and appeals procedures
- Notify plan participants of the changes
- Work with insurers and third-party administrators involved in administering plans that offer disability benefits

Feel free to contact the author of this article for more information and assistance.

Providing Certain Fringe Benefits Now Results in UBIT for Tax-Exempt Organizations

FREEMAN L. LEVINRAD

FEBRUARY, 2018

The Tax Cuts and Jobs Act (the "Act") contains a provision that requires tax-exempt organizations to recognize unrelated business income tax (UBIT) on certain fringe benefits offered to their employees. This change became effective January 1, 2018. It is important for tax-exempt organizations to understand how and why these fringe benefits will now result in UBIT.

UBIT is an income tax that must be paid by tax-exempt organizations on income from an ongoing trade or business that is not substantially related to the charitable, educational, or other purpose that is the basis of its tax-exempt status. UBIT is taxed at the then-current corporate rate on income taxes, which is currently a flat 21%. Section 13703 of the Act amended Section 512(a) of the Internal Revenue Code (the "Code") to add a new paragraph (7), which provides that nonprofits must recognize



UBIT on the value of the following fringe benefits:

- Qualified transportation fringe benefits (e.g., transit passes and transportation in a commuter highway vehicle),
- Parking facilities used in connection with qualified parking, or
- On-premises athletic facilities.

Prior to the Act, both nonprofit and for-profit employers could provide these fringe benefits without recognizing the amounts as income, and employees receiving these benefits would also not be subject to taxation. (For a discussion of tax reform changes affecting employees' taxation, see our [article](#) dated December 27, 2017). The Act eliminated the ability of for-profit employers to deduct these amounts and, apparently to create parity between nonprofit and for-profit employers, required nonprofits that provide these fringe benefits to be taxed on the amounts as UBIT.

As an example, take a university which provides its 1000 employees free access to the university's athletic center, which normally charges a membership fee of \$1,200/year. Under the Act, the university will now be taxed on these fringe benefits at a 21% rate, for a total tax bill of \$252,000.

In light of this change, employers will need to determine the increased cost of the fringe benefits created by the UBIT treatment and evaluate whether these benefits can be restructured with a more favorable design. For example, with respect to qualified transportation benefits, employees can have the amount necessary to pay for these benefits deducted from their pay on a pre-tax basis. If an employer increased employee compensation in the amount of the fringe benefit, employees could still receive the same benefit and the same cost through payroll deduction. That revised benefit structure would avoid UBIT treatment for qualified transportation benefits.

Please contact us if you have any questions about the tax treatment of fringe benefits for your tax-exempt organization.

FIRM NEWS

On January 31, **Robert Gower** was a speaker at Invesco's 2018 DC Summit — Agenda. He gave a talk entitled, *What Comes Next?*

On February 7–10, **Tiffany Santos** and **Callan Carter** presented at the ABA Labor and Employment Law Section Employee Benefits Committee Midwinter Meeting in Clearwater, Florida. They lead discussions on the latest legal topics impacting the industry and cover a variety of topics on the most significant developments in employee benefits law.

On February 7–10, **Trucker Huss** was a Silver Level sponsor of the ABA Labor and Employment Law Section Employee Benefits Committee Midwinter Meeting in Clearwater, Florida. Trucker was also a speaker sponsor for the Diversity and Inclusion Luncheon on February 9 at that event .

On February 15, **Marc Fosse** spoke at a Strafford live webinar entitled, *Nonprofits and Exempt Orgs After Tax Reform*.

On February 22, **Clarissa Kang** is presenting at the American Conference Institute's national forum on Litigating Disability Insurance Claims held in Philadelphia. Her topic is entitled, *The Evolving State of New Remedies and Equitable Relief Under ERISA 502(a)(3)*.

On February 22, **Marc Fosse** is participating in a webinar entitled, *The Tax Cuts and Jobs Act: How it Will Impact Executive Compensation*. The webinar is being presented by The Knowledge Group, LLC. (3–4:30 PM)

On February 28, **Marc Fosse** will be a speaker at the 2018 Community Health Centers Industry Challenges sponsored by Hefernan Insurance Brokers. Marc will address the potential effects of the tax reform bill on employer-provided employee benefits.

The Trucker ♦ Huss Benefits Report is published monthly to provide our clients and friends with information on recent legal developments and other current issues in employee benefits. Back issues of *Benefits Report* are posted on the Trucker ♦ Huss web site (www.truckerhuss.com).

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In response to new IRS rules of practice, we inform you that any federal tax information contained in this writing cannot be used for the purpose of avoiding tax-related penalties or promoting, marketing or recommending to another party any tax-related matters in this *Benefits Report*.